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SUBJECT: AMBASSADOR HOLMERQS NOVEMBER 7 MEETINGS IN BEIJING

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1. (SBU) Summary. In November 7 meetings in Beijing, Chairman Liu He of the Central Leading Group on Finance and Economics asked Ambassador Alan Holmer to convey ChinaQs support for the upcoming global financial summit and for measures taken individually and collectively by G-20 members. He reviewed some of ChinaQs policy responses to maintain growth, and detailed why the (RMB) exchange rate was a Qcomplicated issue.Q China Construction Bank Chairman Guo Shuqing said China could be a source of equity to the under capitalized U.S. banking sector, although the U.S. QmentalityQ and political climate vis--vis Chinese investment needs to change for this to occur. State Food and Drug Administration (SFDA) Commissioner Shao Mingli reviewed current bilateral pharmaceutical regulation and trade issues, while Standards Administration of China (SAC) Administrator Ji Shengkun discussed food and product safety concerns. End Summary.

#### Summit on Financial Markets and the World Economy

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2. (SBU) Regarding the November 14-15 summit in Washington, Chairman Liu He of the Central Leading Group on Finance and Economics asked Ambassador Holmer to pass the following message to senior USG officials: Chinese senior leaders support the global financial summit and will support measures taken individually and collectively by G-20 members. To contribute to global growth, China will take measures to maintain its own growth. China does not want to see radical change to the international financial architecture; while important, such reform will take time and China does not want to see radical changes. A more pressing need is to stabilize financial markets, which requires that leaders signal they will work together. As global economic growth slows, the risk of protectionism rises.

#### Chinese Economic Policies

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3. (SBU) Chairman Liu reviewed some of ChinaQs current and planned policy initiatives. He said the Economic Work Conference will focus on how to maintain growth in the short-term, while promoting medium-term structural reforms such as less-energy intensive growth and the development of higher value-added industries. Liu agreed that these two objectives could at times conflict. Following the investment boom of the last several years, Liu said economic policy makers increasingly are concerned about

excess industrial capacity. The upcoming fiscal stimulus will include both tax cuts and spending increases. Liu opined that tax cuts, particularly for businesses, are usually the most efficient way to promote growth. However, during sharp cyclical downturns, given businesses deteriorating outlook for future growth, he does not expect tax cuts to spur investment in additional productive capacity. Economic policy officials prefer to keep the overall VAT tax rate steady and applicable to all goods, and then adjust the rebate as needed to support targeted sectors. Increasing investment in railways will be an important element of fiscal stimulus, although there is concern about how efficiently the railway monopoly can spend additional resources. Also, recent public reports of planned railway investments overstate likely spending, as the Ministry of Rails is using the press to push for a larger budgetary allocation. Finally, with global oil prices falling, China will reform gasoline prices next year and bring domestic prices in line with international prices.

#### Exchange Rate

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¶4. (SBU) Chairman Liu called the Chinese Renminbi's (RMB) exchange rate a complicated issue. Officials in eastern provinces, SMEs and workers in the export sector are angry with the central government for letting the RMB rise against the US dollar. Even without further RMB appreciation, SMEs face higher labor costs and declining profits. Liu stressed if the RMB strengthened further against the US dollar, there would be unrest in these

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sectors. Liu foresaw continued conflict between political pressures in China (for exchange rate stability) and abroad (for continued RMB appreciation). (Note: Liu's remarks reinforce those from other interlocutors that the Chinese public tends to view the relative strength of the RMB almost entirely against the U.S. dollar, suggesting the Chinese government is likely to continue to tolerate further appreciation on a trade-weighted basis as long as appreciation is limited against the U.S. dollar. End comment).

#### U.S. Economy

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¶5. (SBU) Chairman Liu believes the worst of the U.S. financial crisis is almost over. Now a greater concern is the strength of the U.S. real economy and its impact on China.

#### Climate Change

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¶6. (SBU) Chairman Liu said Europeans (including the Swedish Prime Minister and the UK Foreign Minister) told him they will push aggressively for a sharp reduction in global carbon emissions. He also said those leaders have characterized China's stance on climate change as productive and the U.S. stance as unhelpful. Liu said the U.S. and China should discuss, perhaps in the SED, how to respond to any EU proposal.

#### China Construction Bank

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¶7. (SBU) Chairman Guo Shuqing of China Construction Bank (CCB) told Ambassador Holmer he welcomed the Fed's easing of monetary policy, although he worried about its long-term inflationary impact. Guo also was concerned about rising concentration and market dominance by a few firms in certain U.S. dominated sectors (such as computer operating systems and Microsoft). Regarding counter party risks, the CCB believed that even after TARP equity injections, U.S.

banks remain under capitalized, particularly as U.S. housing prices are expected to fall further and mortgage defaults to rise. Given the expected weakening in U.S. economic growth, CCB was concerned whether \$700 billion to inject equity and purchase impaired assets sufficient.

¶18. (SBU) Guo said China, the Middle East, and other state-owned investors can be a source of equity to the under capitalized U.S. banking sector. Both the China Investment Corporation (CIC) and China's State Administration of Foreign Exchange (SAFE) would be willing to take 10-15% stakes in U.S. financial institutions. For this to occur, however, the U.S. mentality and political climate vis--vis these kinds of investors needs to change. The U.S. Government appears unwilling to let Chinese banks take large equity stakes in U.S. banks. While noting that Chinese banks do not seek operational control of U.S. institutions, Guo doubted that the U.S. Congress or public would accept even a 10% stake by a Chinese bank in a large U.S. bank. Even setting up a single U.S. branch takes forever; CCB first sought a branch license in the mid-1990s.

¶19. (SBU) Regarding Chinese banks' reluctance to extend RMB credit to foreign banks, CCB had held what it thought were low risk bonds of several U.S. financial institutions that went bankrupt, including Lehman. It therefore was not surprising that when risks in lending to U.S. financial institutions increased, banks reduced their exposure. Guo thought lending constraints to foreign banks had now eased.

¶10. (SBU) Guo said investment growth was falling significantly among CCB's corporate clients, who suffer from excess capacity. Banks' lending to local governments also has been cut back, as the expected decline in property prices has reduced property developers' demand to lease land; those leases had been an important source of collateral for bank lending. Rather than pressing banks to support borrowers, as it had done in previous cyclical downturns, and which led to the accumulation of large non-performing loans, the Chinese government will provide tax breaks or subsidies directly to borrowers.

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¶11. (SBU) Finally, Guo claimed that Chinese macroeconomic imbalances are smaller than indicated by official data, which undercounts substantially the provision and consumption of services.

#### State Food and Drug Administration

¶12. (SBU) State Food and Drug Administration (SFDA) Commissioner Shao Mingli told Ambassador Holmer that the SFDA already has posted on its website a list of drug companies that meet GMP standards and have manufacturing and export licenses, while a similar Chinese-language list of licensed exporters has been provided to the FDA but not posted online. (Note: Under the SFDA-HHS Memorandum of Agreement on drugs and medical devices, SFDA is required to post these lists online by June 2010. End note.) Shao emphasized that importing countries are responsible for regulating their own markets, so it might be more fruitful for the U.S. to issue a list of importers (or perhaps products) that must be registered with the FDA. In response, Holmer observed that while a Chinese-language list is helpful, what U.S. companies need more is an English-language list of licensed exporters available online.

¶13. (SBU) Asked whether the SFDA prohibits the export of drugs not registered with SFDA or not in conformity with GMP practices, Shao said export policy is not set by SFDA and related rules are established at AQSIQ. He claimed it is not practical for SFDA to issue a positive list of "approved" companies to the AQSIQ, although that issue is

under discussion with the FDA. Holmer emphasized that finding an appropriate solution would be beneficial to all sides, and noted that the SED is a mechanism for inter-agency cooperation if necessary. Regarding the existing supervisory loophole on production of active pharmaceutical ingredients (API) by unregistered companies, Shao said SFDA has banned purchase by drug manufacturers of API from any non-certified company, and also suggested that the FDA should ban importation of drugs or API from companies not certified, registered and licensed to produce API. Finally, Holmer raised U.S. concern about Chinese dietary supplements that have been found to contain active drugs, including Viagra or similar pharmaceuticals. Shao said SFDA had already provided information to the FDA concerning this matter, and has banned the use of any medicine in foods and dietary supplements. He said the SFDA has little information on companies making such products.

#### Food and Product Safety

¶14. (SBU) In a meeting with Administrator Ji Shengkun of the Standards Administration of China (SAC), Ambassador Holmer asked whether previous responses to product and food safety problems could guide or inform policy-makers on how the U.S. and China can strengthen cooperation in the area of product safety. Ji detailed China's unilateral responses to recent problems with melamine contamination in milk and milk formula. He also described provisions of an improved food safety law as well as AQSIQ's new oversight and inspection responsibilities. Ji's overall tone, however, was somewhat defensive and echoed official media statements suggesting that problems with China's product safety are largely fabricated by an overzealous media. Ji did not offer any suggestions for stronger food and product safety cooperation between the US and China.